RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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Hopes of holding the line to 7.2% this year have virtually been abandoned

A new mood of pessimism is beginning to grip the Carter Administration's sagging anti-inflation program. After months of upbeat talk, the White House is being forced to shift its emphasis from cutting the inflation rate to containing it.

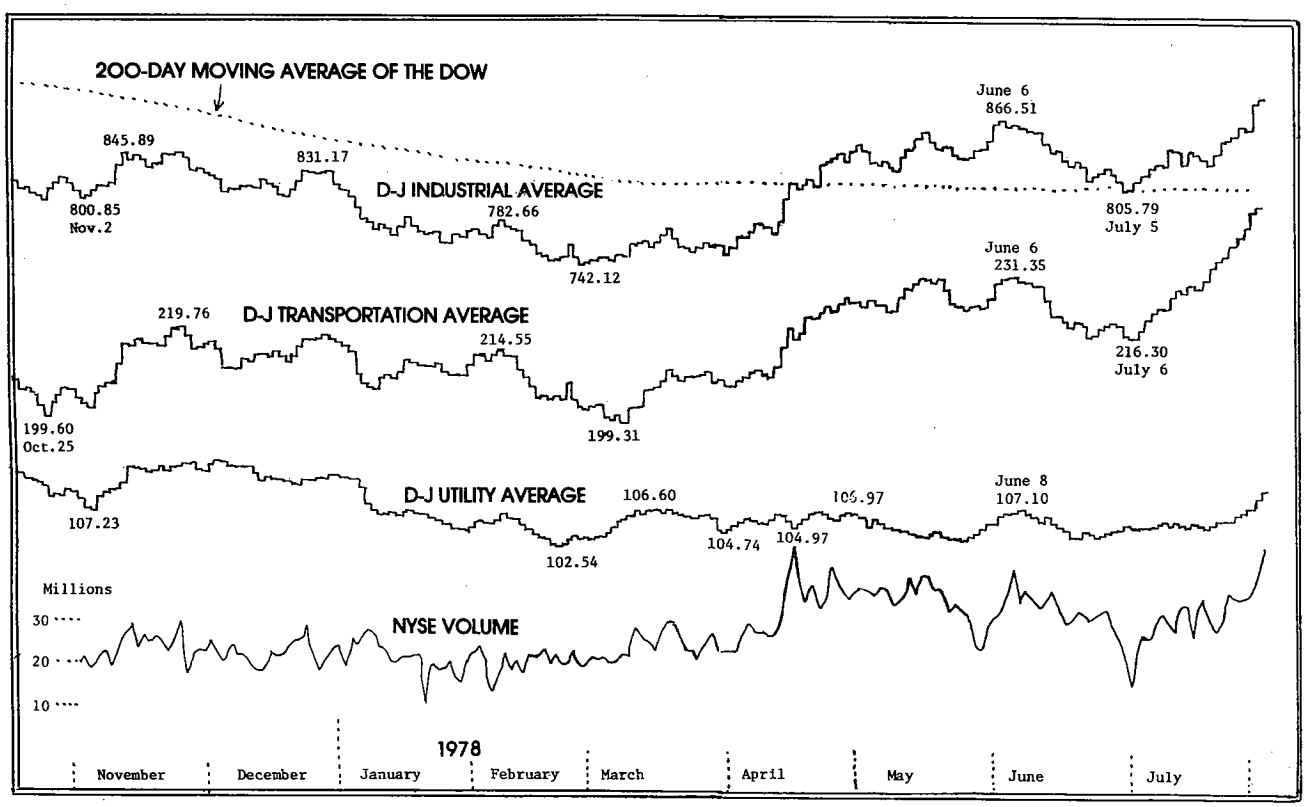
The financial markets have read this to mean that President Carter has virtually abandoned hopes of holding inflation to a 7.2% rate this year and has accepted inflation of closer to 8%. This perception already has helped to send the dollar plunging again in the foreign-exchange markets and has prompted a sharp rise in the price of gold.

WHAT I REALLY THINK: I just cut this out of the latest (Aug. 14) *Business Week*. And of course, we knew this was coming. Under the pressure of the massive, **compounding US debt**, Carter, Miller, Blumenthal and everyone else are being forced to backtrack on their promises and on their efforts. As I've said before, the US has passed the "point of no return" on debt. We are now in the era of "inflate or die." In a later section of this report I show why the US can't take another recession. And that's part of the whole tragic story.

In the meantime, we work for dollars, we trade stock for dollars, we sell homes for dollars, we live by dollars. But the dollar represents an obligation. The dollar is a liability of the US Government. How does the Government survive under the burden of all this debt? Easy, it reduces its liabilities by *reducing the value* of the unit of all US liabilities—the dollar.

There's no question in my mind that the US is moving towards increased inflation, and it will move (while mouthing pious words) until there is either (1) a worldwide panic out of dollars, (2) an official moratorium on all US debt, (3) a declaration of official bankruptcy, (4) a depression which will tend to squeeze all the inflationary water out of everything. In the bankruptcies that will follow, the net amount of dollars will be vastly reduced.

For the American, there is only one way to protect himself. And that is in non-dollar denominated items. That means foreign currencies or gold. Since exchange controls will effectively cut off foreign currencies at some future time, the only real safety will be gold. The *long-term path* of gold will be up. The path may be jagged, it may be difficult, it may be circuitous. But it will be up. Unfortunately, gold stocks are paper, gold futures are paper, gold I.O.U.'s are paper, gold promises are paper. Gold coins in the vault (and hopefully gold bullion in the bank held in your name) are real money. I urge all subscribers to embark on a POLICY of gradually switching their available assets more and more to gold. It isn't a question of US intentions or Government desires any more, it's a question of the US Government's **survival**. Any Government will do anything it has to—to



perpetuate itself. Our Government has chosen inflation as the way to reduce its crushing liabilities. We have only one ultimate defense against the ultimate declaration of bankruptcy–GOLD.

HIGH DRAMA: Here's the July-August calendar of events. On July 28 gold closed above $200 for the first time in history. On July 31 the Treasury 8's of 1996 (bonds) pushed above 94, my "target level" for a reversal (upside) in the bond market (see Letter 734. page 6).

On August 2 the Dow roared 22 points to close at 883.49. The Industrials confirmed the prior new high by Transports and thereby provided a Dow Theory bull signal. On the same day the Dow bettered the 50% level (which was 878.45) of the preceding decline. These points were each described in detail in the last Letter.

On August 2 Utilities closed at 107.24, their best level since January.

Question: Russell, what's happening?

Answer: What's happening is what I suggested "might happen" in the last Letter. The Fed is letting the dollar go. It's saying to Europe and Japan, "You support it, you sweat it, you worry about it. We have our own worries." Obviously the Fed has elected (incredibly) to let the dollar make its own way in the World. while it (the Fed) accommodates the Treasury in its massive 1978 deficit financing. The bond market saw Miller for what he was (all talk), and it headed up, up and away. The stock market took the slide in interest rates as bullish. And the word on Wall Street was "Buy!" In fear of missing what could be a major move, the institutions roared into the stock and bond markets.

Question: What do you think, Russell? Should I play the move?

Answer: As I said in the last Letter, this move is just not my cup of tea. But then I've sweated enough for one lifetime, and what I can skip the next guy may make a fortune on. So I wouldn't fault anyone who bought the bonds on the breakout. And I wouldn't fault anyone who jumped in and bought my list of stocks (see last Letter).

Question: But you still sound skeptical, Russell.

Answer: Look, I've said over and over again that I have a PROCEDURE for handling my money. One of the basic elements of my procedure is that I only buy stocks when my criteria signals a major, over-sold bottom. I did not get that kind of signal during 1978. So I pass. I don't play the horses either, and I don't gamble in Vegas, yet I can understand those who enjoy a bit of excitement for their money. I have a personal game I play, and it's called "try to eliminate risk." I like it that way. And one of the methods I use to try to eliminate risk is to "pass" on hot markets that don't meet my criteria. That's why I can't get excited about this market.

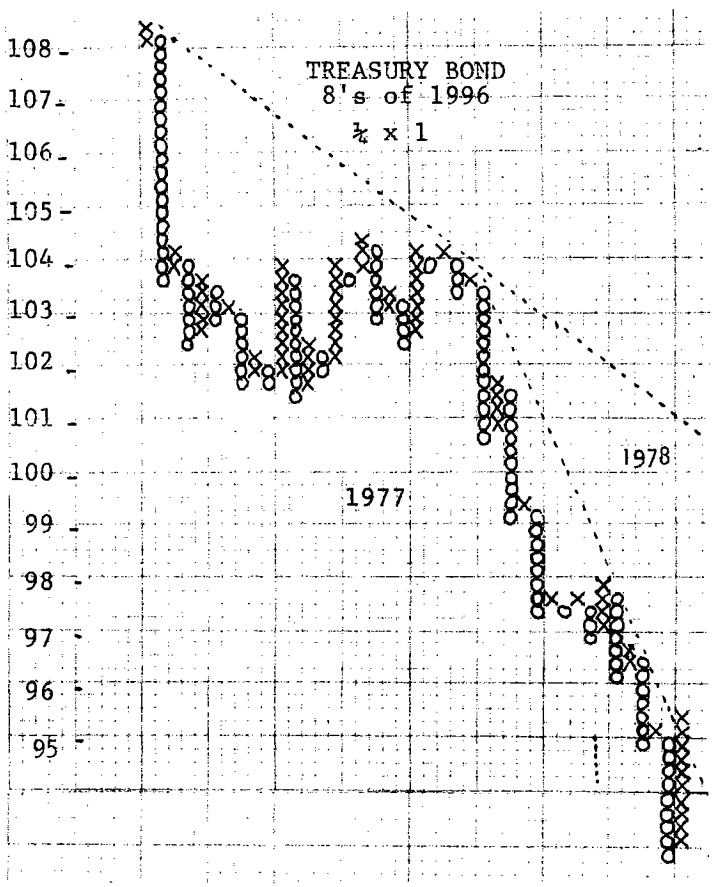
MARKET: Glancing at the page 1 chart, you'll notice that whereas the Transports were "reluctant dragons" on the march to the June 6 highs, the Transports have definitely been the leaders on the latest advance. Moreover, the A-D ratio recorded a new high since 1974 and the Primary Trend Index established a new 1978 high. Utilities, while still sluggish, did move above all peaks going back to January. Strangely, the only lagger is an index that is seldom followed. It's the A-D of the 30 Dow stocks. This index has lagged badly, which simply means that fewer and fewer of the Dow Industrials have participated in this rally.

Technically, it's hard to fault this rally. It's hard to say, "mmm," or "It's not good enough for me." Technically, the rally looks good with the single exception of the record volume of August 3 (65 million shares). Record volume always bespeaks of frantic-ness and "everybody in," and it was the huge volume on June 6 that terminated that advance.

So it isn't the technical data that bothers me about this market, it's the monetary background. It's the knowledge that the Fed under Miller is pouring gasoline on the fire that disturbs me. Gasoline makes a hell of a fire, but gasoline also burns fast, mighty fast.

What to do? I listed six stocks in Letter 735 (page 2) that I liked in the event of a bull signal and particularly in the event of the Dow bettering 878. All that occurred on August 2, and those who elected to play this market should have purchased them the next day. Again, I'll say that I personally did not buy on the bull signal. I'm going to be a spectator on this one.

One more item: my odd lot index is at the point now where every rally of the past year has halted and where every decline has started. It will be most important to note how this market acts following the next decline (which should begin rather soon).



BONDS: In Letter 734 I stated that I thought the bond market could be near a turn. I showed a daily chart of the Treasury 8's of 1996 which were in a long downtrend. I wrote that "one of these weeks or months the bonds are going to rally and break the trend-line. The 8's of 1996 would have to push a bit above 94 to better the trendline at this time."

On July 31 the 8's pushed out of the upper trendline and above 94. Technically, this was the "buy signal." I take it from many calls received that a goodly number of subscribers took positions in the bonds (and in the money markets in general).

Question: What kind of a move do you think this is going to be in bonds?

Answer: I really don't know, but I do *not* think that it's a primary move; I do think that we're seeing a correction against the main or primary trend of the bond market. I have included my point & figure chart of the Treasury 8's of 1996. On the chart the bonds have "broken upside" at 95.40, which is a full point higher than my daily line chart breakout required. But either way, the bonds have reversed and are in an uptrend. Now note that the bonds came down from 108 to 93, an extraordinary collapse for Treasuries. Technically, the bonds could come back at least one-third to halfway. This could bring them back to the 98 or even the 100 area.

Question: How do you know that this isn't the beginning of a new primary bond bull market?

Answer: I'm guessing that it isn't, and I base that on the debt build-up. I see nothing to suggest that the Government financing is going to lessen as the months and years pass. I see nothing to suggest that our Government has decided to spend less. But this in no way indicates that one shouldn't enjoy the rally. The fantastic 1978 smash (see chart) suggests an over-sold condition and the need for an upward correction. But I still believe that new highs in interest rates are coming. Maybe not until 1979–but they're coming.

THE BIND: I am including two charts which, I believe, te ll a rather grim story. The first chart shows three major categories of credit in the US. These are "rate of change" graphs, and they are based on the rate of change on a year-to-year basis.

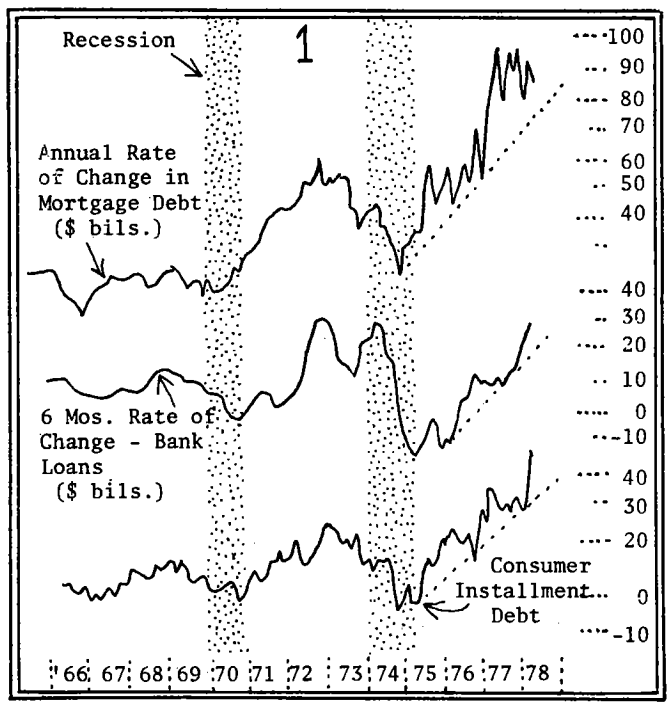
At the top of chart no. 1 we see mortgage debt, which has been in a four-year explosion. The second index shows bank loans to business, while the bottom index traces consumer installment debt. As you can see, the three lines are currently in the **greatest accelerated uptrend** in history.

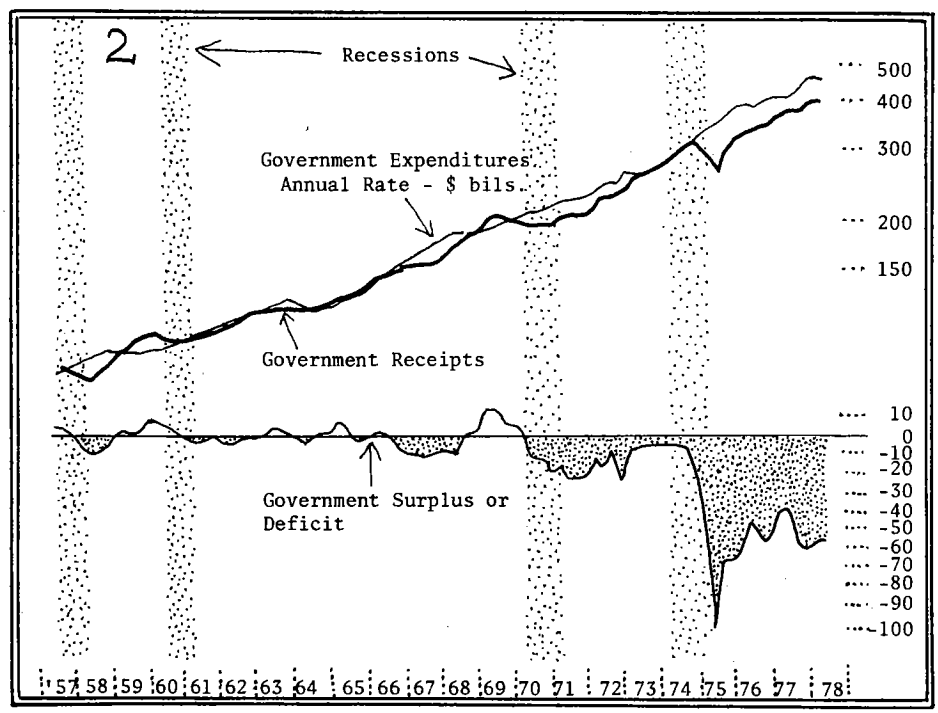
I have drawn rising trendlines which track the rates of ascent on each index. Of course, no one knows how long these upward thrusts can continue, but already mortgage debt is showing signs of topping. Business bank loans and consumer installment debt, however, are still pushing up. My guess is that all three lines will be turning down sometime during the last quarter of 1978 or in 1979.

The vertical shaded bars on the chart represent periods of economic recession. Note how (particularly during 1973-74) the plunge or unwinding of the three credit categories were instrumental in throwing the nation into recession. The fact is that the US economy cannot withstand a decline in housing, business expansion, and consumer installment buying. Thus, when the three lines are again in established downtrends, it is a sure bet that the US will be going into recession.

Now let's turn to chart no. 2. This is a critical picture which few people understand. The lighter line at the top of the chart is simply US Government expenditures. The heavier line represents Government receipts (mostly tax receipts). As you can see, total Government expenditures just keep rising. They keep rising through the good times, and they keep rising through the bad times (the bad times or recession are the vertical shaded bands).

But here's the crux of it; note that during each recession receipts fall off. The lower line on the chart shows the Federal surplus or deficit (the deficit is the shaded portion below the zero line). During the 1970 recession the deficit started to expand. Then as the economy picked up during 1972 and 1973, the deficit shrunk slightly. But by 1974 (with Government receipts falling sharply)





the deficit expanded to horrendous proportions. And since 1974, despite great infusions of Federal credit (with accompanying inflation) the deficits have continued to roll in.

This chart provides us with a dramatic picture of WHY THE GOVERNMENT IS SO TERRIFIED OF RECESSION. By the same token the chart shows us why the Fed has refused to clamp down on the interest rates and money supply. It's obvious–the Fed's fear is that during the next recession there will be a massive fall-off in tax receipts, in which case the bottom index chart (the Federal Deficit) will drop off the bottom of the page. After all, if the kind of credit explosions depicted on chart no. 1 can't produce Federal surpluses, what kind of Federal deficits are we going to see when those credit explosions turn into credit contractions and today's corporate profits turn into lesser profits and in many cases–losses?

A few weeks ago Fed Chairman Miller stated to a group of Government securities dealers, "I'll make as many tightenings of the monetary screws as necessary to wring out inflationary forces, but I don't want to bring on a recession." Then he said that the Federal deficit would "go over $100 billion" in the event of recession, and "we can't let that happen." My only comment is that the figure of $100 billion is a very conservative one. My guess is that the next recession will see the Fed open the monetary gates wide, and that we'll see deficits well above the $100 billion level.

Ponder on this: if the Fed is willing (as it now is) to make money relatively easy and available during a period of exploding credit demand, what will they be willing to do when the economy is reeling and monetary stimulation is called for? The implications are frightening, and at that time we may see what amounts to the virtual destruction of the dollar.

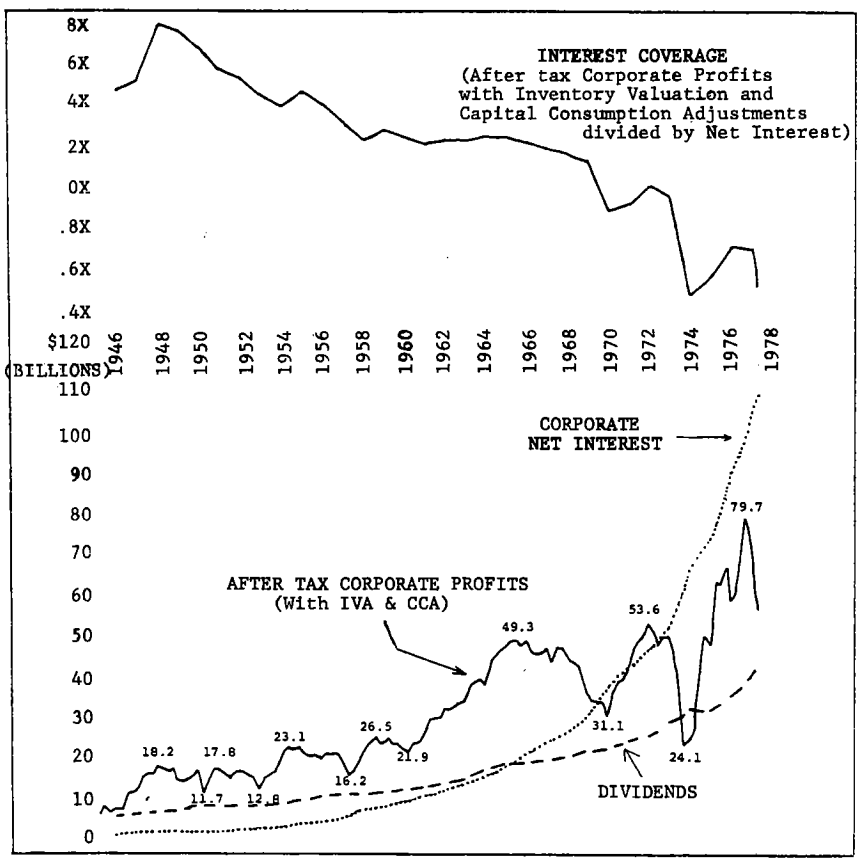
At that time, in the face of massive (perhaps totally unbelievable) deficits, I would expect gold to go into its third and final bull phase. And that should see the metal climb to prices that would surprise even the most optimistic of today's gold bulls.

CORPORATE BIND: In preceding sections I talked about the Fed's dilemma and the problems of the compounding of debt. Now I want to talk about the corporate dilemma–or perhaps I should label it "the corporate version of Jaws."

In Letter after Letter I have attempted to show subscribers how the process of compounded debt is eating the nation up alive. But it would be well to realize that this is not just a Governmental tragedy. For the fact is that the process of compounding debt is eating up the consumer and the business sectors as well. The US is on a debt-creating binge that has no parallel in the annals of recorded history. And before it's all over, I firmly believe that we will fully understand the warning of old Polonius (from Hamlet) when he said, "Neither a borrower nor a lender be."

A few weeks ago I received a report written by my friend, Ned Davis, of J. C. Bradford & Co. One chart in the report struck me as so important that I immediately called Ned to congratulate him on this study, as well as to ask permission to use the chart in my next Letter. The chart is reproduced below.

What we see here is an ominous picture of what has happened to total corporate profits vs. total corporate interest payments. At the same time the chart provides a depressing picture of things to come. The picture is simple enough–it is clear enough. At the bottom of the chart we see after-tax corporate profits rising from their 1946 base, rising to the peaks of 1966, then dropping to the low $24.1 billion low of 1974, then exploding to the $79.7 billion high of 1977. But what few people have noticed is the sudden drop-off of profits to the latest figure of $57 billion, a drop of 28%.



The dotted line curving exponentially higher is total corporate interest costs. This is rising at a rate of about $14 billion a year! Note that in the year 1973 total interest costs surged ABOVE real profits. Thus, the year 1973 represented the "point of no return" in that this was the year in which interest costs surged decisively above total corporate profits. From here on, the corporate structure in the US was living on borrowed time (and borrowed money).

The dashed line at the bottom of the chart shows the dividend payout for all corporations. Interestingly, it was the year 1966 when total interest costs pushed above total dividend payouts. That was the year when corporations started to pay more for their borrowing than they were able to pay to their stockholders. Significantly, very significantly, 1966 was also the year of the great 1949-66 bull market's end.

The situation continues to deteriorate at a rapid rate. The top line shows the ratio of corporate profits to interest costs. Many call this the ratio of "interest rate coverage." Around 1969 this ratio dropped below 1, and that meant that there was less than a dollar of earnings for every dollar of interest cost. Most recently, this ratio has been plunging towards the .4 level, the level at which only 40 cents of profits are generated to cover each dollar of interest costs.

The conclusion is both simple and frightening. In the next recession (whenever it arrives) real corporate profits are going to disappear as interest costs continue to surge and the ability to carry these interest costs collapses. At that time there will be an across-the-board slash in dividends that will probably equal that of the early 1930's. Corporations, in the face of rocketing interest charges and non-existent profits, will be forced to cut dividends in an effort to survive. Such conditions will provide the seeds for what I believe will be one of the worst collapses in stock market annals. But those same seeds will ultimately pave the way for the next truly major bear market bottom.

GOLD: As the dollar goes down against other nations' strong currencies, these nations (Japan, Germany) are forced to raise the prices of their goods. As foreign goods (Datsuns, Toyotas, BMW's) increase in price, domestic manufacturers raise their prices (in order to show bigger profits and offset domestic cost increases). Thus, after decades of the US exporting its inflation to Europe and Japan, Europe and Japan are now **shipping the inflation back to the US** via their higher prices.

But the ominous part of this whole picture is that the dollar's horrendous fall is foreshadowing a decline of power in the US. Judging from all history, a nation's power and prestige can be gauged by the strength and prestige of its currency.

Where currencies lose their luster, so does the nation that produces that currency.

Already the US inflation and the fall of the dollar is producing a "feeding-on-itself" syndrome. The OPEC nations will meet shortly to consider a 10% increase in oil prices. They will also vote on a basket-of-currencies for oil pricing rather than the dollar. The basket will also contain some gold. Meanwhile, Europe (nine nations) is preparing a new European ECU and a $50 billion fund (not dollars) which will be used to support the ECU. Europe, like OPEC, is turning away from the dollar.

The fundamentals of the situation are clear enough. The US, long the world's great producer, is now a **consumer** nation. Everything in the US is being geared to consuming, and of course Carter is the very essence of the "consumer advocate." Germany and Japan are now the producers, and the chances of reversing this situation (given the present political and social environment) are slim indeed.

The technical position of gold is becoming increasingly interesting. I am including my chart (page 6) of gold momentum which is a 13-week *rate of change* index for gold. As you can see, the momentum index turned down in December, 1976, and it has been trending down ever since. Last week, for the first time in almost two years, gold momentum turned bullish as the index recorded a figure of 120. This is a very important technical achievement for gold, but it will also be important to see whether the metal can continue its new bullish momentum trend. At a price of 215 (if that figure is hit in the next few weeks), gold momentum would hit 125, thereby bettering its 1976 peak. If that happens, gold would look undeniably strong.

The second chart shows *daily* gold with the three moving averages which I keep on the metal. The 50-week or "primary trend average" for gold hit 171 last week. I feel that this MA (which is now climbing at the rate of a point or two each week) indicates the long-term direction for gold. The 13-week MA for gold is now 186, a level at which we should see very strong support in the event of a reaction. The 4-week MA for gold is 195.15. I consider the current push in gold above the psychological 200 barrier to be exceedingly important. If gold can hold above 200, I would consider such action highly significant.

It takes the public (and investors) time to accept a **new level** in any stock or commodity. Gold has never been "over 200 an ounce" before. If gold can hold 200 it will be **accepted** at this price before long. I would then expect gold to start moving higher. Within a year (assuming gold can hold near or preferably above 200), I would expect gold to be at startlingly higher levels. I will talk about some of my projections in the next report.

Question: Russell, the stock market's been doing beautifully of late. Gold has too, but why have you been emphasizing gold so heavily all year?

Answer: Let me put it to you my way. I have two reasons for emphasizing gold. One is altruistic, the other is selfish. Altruistically, I like my subscribers, they are good people, they work hard at thinking this whole business through, and I want them to do well in the very difficult years ahead. I think they will do well with gold.

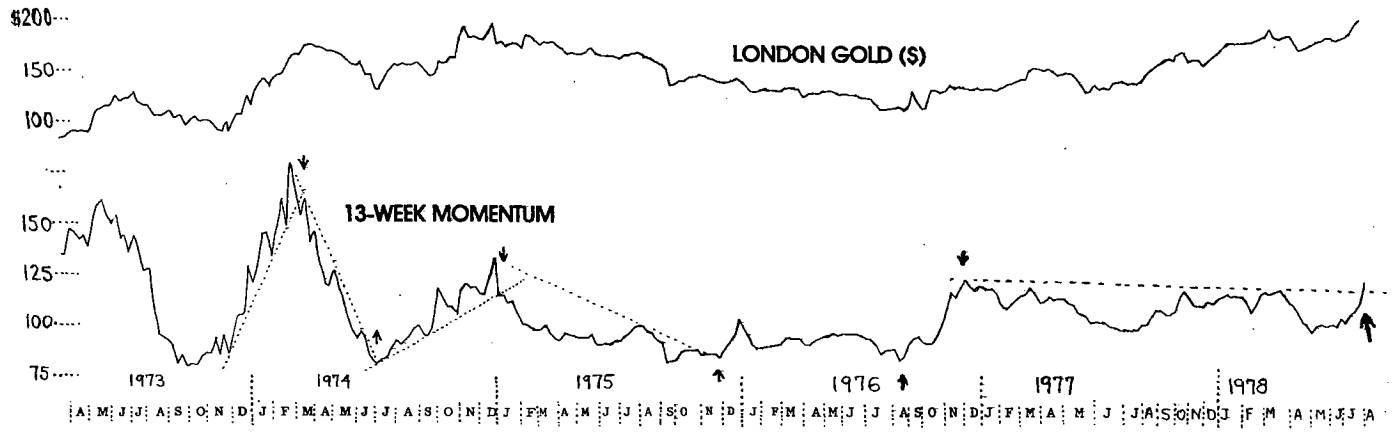
On a selfish basis, I've been successful in the advisory business. I support myself and a lot of other people with these reports. I'd like to continue with something like the same degree of success. If my subscribers survive and are happy, have peace of mind and prosper, I'll have a chance to do the same thing.

The US is on a treadmill to disaster via the creation of debt. In time (and the time is moving very rapidly now) the debt will destroy almost ALL forms of investments. Gold will withstand the destruction, because real money is never destroyed. I am adamant about my subscribers getting into gold because I believe gold is going to be our survival mechanism. As most, if not all, of my subscribers get into gold they will "get used to the idea," and they will increase their positions. This will be their best way of withstanding what I see as the coming great monetary and financial crisis of the US. When the average American finally sees how his assets are being systematically destroyed, there will be a move into gold that will amount (I believe) to an historic buying panic of unbelievable proportions.

FUTURES: Commodity trading is widespread today. It is increasingly popular because there is tremendous action and tremendous leverage in trading commodities. My personal objection to commodity trading is that amateurs almost always get taken out with losses. My second objection to trading commodities is that it is very difficult to ride the major trend (of any item) with futures contracts. The odds are that you will HAVE to trade the contracts. If you don't, you're going to end up with either heart failure or losses.

Nevertheless, I like to follow the commodities, and I've seen most of the commodity chart services. The one I like best is S.M.R., which includes daily charts and valuable trading aids. Their address is P.O.Box 14096, Denver, Colo. 80214.

To give you an example of commodity leverage, a gold futures contract required a minimum of only $1200 down (you'll also pay commissions). The contract is a call on 100 ounces of gold worth $20,000. A futures contract on long-term Treasury bonds requires only $1500 down. This is a call on $100,000 of bonds. If the bonds go up two points, you've doubled your money and



then some. If the bonds go down two points, you've lost your $1500 and then some. Obviously, timing is everything in commodities. You can be right on the long-term trend and lose your shirt.

FINAL NOTES: The 13-week moving average (MA) of the Dow is now only 26 points above the 50-week MA. In 1975 the bullish spread rose to 120 points. Thus, if this rise is to be major we're still "at the fulcrum" at which the two MA's have barely crosssed. For those who wish to try their hand despite my own misgivings, I suggested the following stocks in the last Letter: **TWA, Signal Oil, General Dynamics, McGraw Hill, Squibb, Pullman.** I'm adding to the list of very strong stocks, **UAL, McDonald Douglas, Control Data.**

From the market standpoint, I am now watching the 50% level on the Dow which is 878.45. The Dow rallied above this level late last week, and I am most interested to see whether the Dow can hold persistently above the 50% level of the last major decline (i.e., 1976 to 1978). If so, then technically there is reason to believe that the Dow will in due time try for the 1976 high.

Many term this advance "a flight from currency," and it may be. But since 1966 (the old bull market high) stocks have not proved a hedge against inflation for the simple reason that corporate costs are inflated along with their earnings. But Wall Street has its reasons, and in due time we will uncover the "why's." Right now I am dealing with the "how's," the how the Dow acts in the "above 878.45 area" is what interests me at present.

The whole spectrum of gold stocks has acted well since April, and my gold average is up 33% from April. But I still prefer gold itself. Gold gives us only a single worry. Will the metal go up or down. The stocks present a number of worries, such as earnings, costs, government policies, mine disasters and in S. Africa the problem of racial tension.

On the bond front the bonds have "popped" in a most explosive surge from the late-July lows. The spectacle of bonds, gold and stocks all going up is a great rarity. This "dance" of the three enemies will not continue.

NEXT MAILING: August 21